UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Financial Reporting and Cost Accounting, Oversight and Recovery Practices for Regional Transmission System Organizations and Independent System Operators	**)** **)** **)** **)**	**Docket No. RM04-12-000**

COMMENTS OF THE ORGANIZATION OF MISO STATES

I. Executive Summary

The Organization of MISO States ("OMS") submits the following initial comments in response to the Federal Energy Regulatory Commission's ("Commission" or "FERC") Notice of Inquiry ("NOI") issued September 16, 2004. The OMS concurs that the Commission has identified a set of issues that merit discussion and look forward to further dialogue and opportunities to extend our comments.

First, the OMS generally supports the establishment of accounting reporting requirements that are more relevant to the functions performed by regional transmission organizations and independent transmission system operators (collectively, "RTOs") and their cost profiles. In particular, the OMS is interested in the comments of the National Association of Regulatory Utility Commissioners (NARUC) regarding appropriate accounting reforms. Second, the OMS recognizes the importance of Board oversight of cost control. In this regard, the OMS believes that there are issues of governance, accountability, and appropriate incentives that deserve a more extensive dialogue. Because the interrelationships among these issues are so complex and have potential implications for the independence of the RTOs, the OMS recommends that the FERC consider a separate inquiry to address these issues in a more comprehensive manner. That inquiry should facilitate adoption of new accounting and financial reporting procedures.

Third, the OMS considers some of the issues related to methods of reviewing RTOs' costs and expenditures and suggests areas of potential incremental improvements. Fourth, the OMS provides brief comments regarding rate design and cost allocations across RTOs. In summary, the OMS underscores that these comments support better methods to analyze RTO expenditures that will hopefully lead to greater cost control.

II. Accounting and Financial Reporting Requirements

The OMS represents State Commissions that allow retail competition as well as traditional regulation. Regardless of the differing approaches to retail regulation, the fundamental reliability and successful commercial reforms of wholesale power markets[1] are of common interest to all States represented by the OMS.

Each State Commission within the OMS has a common interest in instituting accounting regimes, emanating from the RTO operated markets, that are transparent and of sufficient detail to allow State Commissions to better ensure that the full benefits as well as costs are appropriately assigned. Much of the costs are not "new" costs (e.g., redispatch, ancillary services, transmission costs – revenues, transmission congestion, losses, and control area costs)

[1] Such reforms include the operation of transparent real-time and day-ahead markets, facilitation of more robust bilateral transactions over vast regions, more efficient provision of ancillary services, market-based clearing of transmission congestion, comprehensive regional resource planning and cost-effective additions of new supply and demand resources, as well as

and are already embedded in base-rates or are allowed to be flowed through in automatic fuel adjustment clauses or other vehicles.

The OMS anticipates benefits associated with more optimal dispatching of power plants than current dispatching affords. State Commissions also recognize that there will be new costs and revenues associated with such things as Financial Transmission Rights ("FTRs") and other instruments. The OMS also expects that there will be significant benefits from comprehensive planning and construction of new transmission, generation, and demand-response programs. As a result, each State Commissions will need to be able to dissect the various operating costs and benefits and, almost certainly, construct new mechanisms to ensure that the costs and benefits are properly assigned in a timely manner.

The design and structure of any cost accounting process or procedure depends, at least in part, on how the information is to be used. How the cost accounting information is to be used is both a public policy and a business decision. As a result, we as regulators must make some decisions about how we wish to use this cost accounting information, which, in turn, will influence how the cost accounting process and procedures are implemented. For these reasons, the OMS generally supports the establishment of accounting reporting requirements that are more relevant to the functions performed by RTOs and their cost profiles. With respect to the questions in Parts B and C of the NOI regarding accounting and financial reporting issues, the OMS is interested in the comments of the National Association of Regulatory Utility Commissioners (NARUC).

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effective market monitoring and – where necessary – mitigation.

III. Cost Control by RTOs

Broadly speaking, an RTO's ability to contain its costs properly depends on several interrelated factors, including the governance structure of the RTO that assures accountability while ensuring the independence of the Board. In another forum, a dialogue concerning governance ought to address some of the reforms proposed in recent years that, among other things, articulate the importance of the composition of Boards of Directors to provide for a diversity of skill sets and expertise on all aspects of RTO operations. Of course, it is imperative that the Board receives the best possible information to facilitate informed decisions. To this end, the organizational structure must be accountable to the Board. Because of its public interest mission, RTOs ought to be accountable to State Commissions and stakeholders in such a way that balances accountability with appropriate degree of independence. Accountability needs to address questions such as "accountable to whom" and "what incentive / disincentive mechanisms might better assure accountability?"

The "right" incentives for RTOs promote appropriate policy goals and efficient compliance with the RTOs' contractual obligations and regulatory requirements, including cost containment. In Order No. 2000 and other rulemakings or organization-specific orders, the Commission has specified policy goals and requirements for RTOs. In particular, in Order No. 2000, the Commission stated a multi-pronged goal for RTOs, "to promote efficiency in wholesale electricity markets and to ensure that electricity consumers pay the lowest price possible for reliable service."[2] In these comments, we highlight the Commission's statement in its November 22, 2002 Order in Docket No.ER02-2595 (at ¶ 3), wherein the Commission stated:

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[2] Order No. 2000, 65 Fed. Reg. 809 (January 6, 2000), FERC Stats. & Regs., ¶ 31,089 (1999), p. 1.

> "We … recognize that RTO development costs must be carefully contained in order to maximize the net benefits of RTO formation and the creation of a common market to customers. Therefore, while we recognize the importance of RTOs recovering their costs associated with the services they provide, we also recognize the importance of cost control measures in system development." Consequently, we expect Midwest ISO's Board of Directors to be proactive in this area.[3] The Midwest ISO Agreement provides that the management of all property, business and affairs of Midwest ISO shall be vested in the Board of Directors. Thus, we expect the Board of Directors to guard against any unreasonable costs being incurred.

Accordingly, the OMS concurs that the Board of Directors must be "proactive" in controlling the costs of an RTO. While we refrain from commenting on the "right" incentives that may be appropriate within these comments, the "right" incentives should be those that help ensure that RTOs' Boards "proactively" and efficiently harmonize cost minimization, which the above-referenced goal (i.e., "lowest price possible") stated in Order No. 2000 implies, with the Commission's other goals and requirements and with RTOs' other obligations.

IV. The Commission's Oversight of RTOs' Costs

In this section, the OMS will provide comments on issues raised by the following set of questions, as enumerated in the Notice:

2. Should the Commission revisit the means by which RTO/ISO rates are reviewed, particularly with respect to cost incurrence? If so, what means should the Commission employ to ensure that RTOs'/ISOs' expenditures are prudent and their rates are just and reasonable? Would a "best practices" or "benchmark" approach, where one RTO/ISO's expenditures in a particular cost category are measured against those of other RTOs/ISOs, be sufficient?

To better gauge the need for the Commission to revisit the means by which RTOs' rates are reviewed with respect to cost incurrence, it is useful to consider the current means of

[3] In a footnote included at this place within this quote, the Commission further stated, "We

reviewing RTOs' proposed expenditures. For example, in its November 22, 2002 Order in Docket No. ER02-2595, the Commission acknowledged the validity of concerns raised by intervenors regarding the level of the Midwest ISO's proposed expenditures for developing and implementing "Day 2" congestion management and energy market services. Nonetheless, the Order's analysis of the prudence of the Midwest ISO's proposed expenditures is limited to summarizing them[4] and generally identifying the sources for Midwest ISO's cost estimates.[5] Despite the Order's limited analysis, the Commission stated "[t]his order will enable Midwest ISO to recover the reasonable costs associated with the establishment of Financial Transmission Rights (FTRs) and the development of Energy Markets." [6]

To address intervenors' concerns regarding the prudence of the Midwest ISO's proposed expenditures and "to facilitate [the Commission's] monitoring function,"[7] the Commission instead directed Midwest ISO to make regular informational filings that must include:

> "… detailed information on costs estimated to be incurred over the following 120 days for each service and detailed justifications for each of the costs; detailed information on the actual costs incurred over the previous 60 day period for each service; and detailed explanations for any cost differences between the budgeted amount for the past 60 day period (as shown in the previous two reports) and the actual amount incurred (as shown in the current report)".[8]

In its April 11, 2003 Order on Rehearing and Clarification in Docket No. ER02-2595, the Commission stated,

> "We clarify that Midwest ISO's informational filings will be used to indicate the expected expenditures and monitor the progress made by Midwest ISO. However, we note that the informational filings are not intended to form the basis of an automatic prudence review of reported

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similarly expect such action by the Boards of other ISOs."

4 Docket No. ER02-2595 Order issued November 22, 2002, ¶ 8, 30.
5 Ibid, ¶ 30.
6 Ibid, ¶ 1.
7 Ibid, ¶ 36.
8 Id.

> costs. Rather, these filings are intended to give the parties advance notice of potential cost issues, which they can then raise via an appropriate filing with the Commission."[9]

In addition, the Commission recognized that, in general, several commenters requested "more detailed information so that they can better evaluate the costs Midwest ISO expects to incur."[10] In response to that general request, the Commission stated, "We agree that more detailed information is required and we order Midwest ISO to address the concerns expressed by the commenters in future informational filings."[11]

The OMS recommends that the Commission consider revisiting the means by which it reviews RTOs' proposed expenditures. The OMS recognizes, however, that reviewing the prudence of RTOs' costs is a complicated matter for a number of reasons. For example, even with properly structured incentive plans, as the Commission has noted, "Midwest ISO's non-profit status complicates a prudence review after the costs are incurred."[12] In addition, RTO development is new terrain for the Commission and many States, which further complicates judging the reasonableness of RTOs' costs. Despite such complications, since RTOs are under the jurisdiction of the Commission, the Commission must conduct any regulatory prudence reviews.[13]

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[9] April 11, 2003, Order on Rehearing and Clarification in Docket No. ER02-2595, ¶ 13.

[10] Ibid., footnote 12.

[11] Id.

[12] Ibid, ¶ 35.

[13] To the extent that some of the Inquiry's questions imply a question of whether the non-profit status of RTOs is a barrier to cost containment, non-profit status is not a barrier to cost containment. With proper incentives and governance, non-profit RTOs can contain costs effectively and appropriately.

The profit motive is most effective for controlling costs and benefiting society in competitive or workably competitive markets. RTOs have natural monopoly characteristics, including significant economies of scale that do not easily lend themselves to socially beneficial competition characterized by free entry and exit by rival RTOs. Moreover, a profit motive in conjunction with the contractual and regulatory difficulties of changes in RTO membership could exacerbate the natural monopoly problem and may require heavier regulation.

Further, RTOs' functions and services create public goods (e.g., non-exclusive consumption of reactive power or capacity) and externalities (e.g., loop flow) that should be provided by monopoly RTOs who, with their members, can most efficiently internalize these benefits and costs. A profit motive could induce social

The Commission could, by way of example, consider requiring RTOs to submit their spending plans sufficiently early to allow for some type of prudence review. The OMS is sensitive to the amount of time any regulatory prudence reviews could take, however, and would urge the Commission to consider means of expediting such reviews if the Commission deems that such a review could serve the public interest. Such an expedited review might be in the form of paper hearings like those used to examine cost allocation issues in Docket No. ER02-2595.[14] Alternatively, the Commission could require RTOs' Boards to certify the prudence of proposed expenditures. The Boards' preparations of such certifications could require the sorts of analyses that otherwise would be part of a review by the Commission.

A "best practices" or "benchmark" approach could be a good starting point for any prudence reviews of RTOs' costs. In its Notice, the Commission observes that there are similarities among RTOs to the extent that each administers a regional transmission tariff and performs system monitoring and transmission scheduling, for example. With input from stakeholders who participate in more than one RTO, for example, the Commission could be

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inefficiencies from RTOs providing too many services characterized by externalities and not enough services with public good characteristics.

In addition, RTOs must cooperate and coordinate with each other in a number of areas (e.g., seams agreements, planning). A profit motive could produce socially inefficient outcomes from such cooperative activities.

[14] After finding "that the proposed billing determinants raise important issues that cannot be resolved based on the information presented," the Commission ordered a "paper hearing" to address intervenors' concerns regarding billing determinants and cost allocations. As the Commission noted,

> "The use of a "paper" hearing rather than a trial-type evidentiary hearing has been addressed in several cases. See, e.g., Public Service Company of Indiana, 49 FERC ¶ 61,346 (1989), order on reh'g, 50 FERC ¶ 61,186, opinion issued, Opinion 349, 51 FERC ¶ 61,367, order on reh'g, Opinion 349-A, 52 FERC ¶ 61,260 , clarified, 53 FERC ¶ 61,131 (1990), dismissed, Northern Indiana Public Service Company v. FERC, 954 F.2d 736 (D.C. Cir. 1992). As the Commission noted in Opinion No. 349, 51 FERC at pp. 62,218 -19 & n.67, while the Federal Power Act and case law require that the Commission provide the parties with a meaningful opportunity for a hearing, the Commission is required to reach decisions on the basis of an oral, trial-type evidentiary record only if the material facts in dispute cannot be resolved on the basis of the written record, i.e., where the written submissions do not provide an adequate basis for resolving disputes about material facts" (Ibid, ¶ 44).

better equipped for comparing certain costs across RTOs in order to judge the reasonableness of proposed expenditures in certain cost categories. For some cost categories, however, the Commission may need to rely more heavily on RTO-specific information.

The OMS recognizes the inherent difficulties in constructing objective and quantifiable criteria for “incentives” and “cost control.” To develop some form of “yardstick” regulation to the extent it is possible to compare various operational costs among RTOs will, necessarily require development of common accounting protocols. If it proves practical, such cost comparisons might encourage efficiency, cost containment, and thereby inspire greater confidence in the markets operated by the RTOs. Certainly, each State Commission (along with stakeholders and the management of RTOs) will want to be able to compare the short and longer-term costs to consumers and market participants.

While the OMS recognizes that cost comparisons among RTOs will be difficult as a result of such things as differing geographical scopes, configuration issues, differing allocations of functions (e.g., the role of control areas) and differing historical costs, the OMS believes that the institution of largely equivalent operational practices for each RTO to foster common markets, may enable some reasonable cost comparisons of various categories of RTO operations. Again, the key to any effort will be establishing similar “sunshine” accounting protocols and methods for comparing differing practices currently in-place (this latter effort is likely to prove to be extraordinarily difficult). In addition, the OMS recognizes that, to avoid perverse and unintended consequences, great care will have to be exercised to not unduly emphasize short-term costs and benefits without due consideration of longer-term costs and benefits.

V. Cost Allocations and Rate Designs Across RTOs

In this section, the OMS will provide initial comments on issues raised by the following set of questions, as enumerated in the Notice:

5. Should the Commission allow differences between RTOs/ISOs with regard to cost allocation and rate design to recover the operation and capital costs for each of their functions (e.g., tariff administration and markets for energy, ancillary service, and FTRs)? If so, how should the various rates be designed, i.e., what are the correct billing determinants for each service?

The Commission should consider allowing differences between RTOs with regard to cost allocation and rate design to recover the operation and capital costs for each of their functions provided that they do not adversely affect the development of "joint and common markets." Permitting regional variations may inspire innovative rate filings and legitimately reflect reasonable differences. Consistent with the aspiration for a joint and common market, for instance, it would not be appropriate for the Commission, without good reasons, to allow an RTO to recover market administration costs from all customers in its footprint under a philosophy that all customers benefit from the market and should therefore share in the cost burden, and then significantly change its philosophy in another RTO. Whether or not there are specific rules in place, the Commission should strive to balance the admirable desire for innovation with the need to send consistent messages that are required for a common market and treat RTO customers in a manner that is not unduly discriminatory.

VI. Conclusion

The Organization of MISO States submits these initial comments because a majority of the members have agreed to support them. The following members support these comments. Individual OMS members reserve the right to file clarifying comments or minority reports on their own regarding the issues discussed in these comments.

North Dakota Public Service Commission
Michigan Public Service Commission
Missouri Public Service Commission
Wisconsin Public Service Commission
Iowa Utilities Board
Indiana Utility Regulatory Commission
Minnesota Public Utilities Commission
South Dakota Public Utilities Commission
Montana Public Service Commission
Kentucky Public Service Commission
Pennsylvania Public Utility Commission

Members not participating in these comments are:

Illinois Commerce Commission
Public Utilities Commission of Ohio
Nebraska Power Review Board
Manitoba Public Utilities Board

The Minnesota Department of Commerce, as an associate member of the OMS, participated in these comments and supports these comments.

Respectfully Submitted,
William H. Smith, Jr.

William H. Smith, Jr.
Executive Director
Organization of MISO States
100 Court Avenue, Suite 218
Des Moines, Iowa 50309
Tel: 515-243-0742

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